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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

Fourth Quarter 1991

A STALLED RECOVERY

The United States economy is distressed. Housing starts are at their lowest level since 1946, and at practically the same level they were in 1925 before the G.I. Bill and mortgage insurance. Auto sales have fallen to the lowest level since the deep recession year of 1982. The Consumer Confidence Index plunged to a recession level of 60.4 in October. Business confidence, as measured by the U.S. Chamber's Business Ballot, plummeted in October to an eighteen month low. For the first time since the Great Depression, real estate values in many parts of the country have declined, undermining confidence and creating fear as people see their single biggest asset erode in value.

After declining for the first four months of 1991, the economy experienced a revival starting in May. Many analysts thought this uptick marked the beginning of a sustainable, albeit subdued, recovery that would last the rest of this year and next. However, the revival was short-lived. By September, upward economic momentum had dissipated and the so-called recovery stalled.

Factory orders fell in August and September, employment was flat in October, manufacturing confidence is dropping, September leading economic indicators fell slightly, housing starts dropped abruptly and the unemployment rate rose to 6.8 percent in October. Inflation rose by 0.4 percent — the largest increase in many months. There was good news, but it was not very good. Industrial production in September rose by just 0.1 percent and the purchasing managers index stayed over 50 but fell by 1.5 points in October to 53.5. The most positive statistics were a 0.7 percent rise in retail sales in September and similar rises in personal income and consumption. However, consumer spending has been rising faster than income. The income constraint and the October plunge in consumer confidence suggests that this good news may not last.

It appears that our year-long forecast of a second dip to the recession will likely come true. We project a small decline in real GNP in the fourth quarter of 1991 (-0.2 percent) followed by another slight decline in the first quarter of 1992 (-0.6 percent). Beginning with the second quarter of 1992, a more sustainable revival will take place. We expect real GNP to increase in the last three quarters of 1992 so that real GNP will grow by about 1.5 percent over the year.

The consensus of Blue Chip Economic Indicators for real GNP growth in 1992 dropped from 2.7 percent in October to 2.4 percent in November. Still, the majority of these forecasters expect real GNP to increase by 2 percent to 3 percent next year. However, we expect real GNP growth in the 1 percent to 2 percent range. Even if the consensus is correct, this will be a record low for a recovery, and it may not feel much better than what has happened since 1989.

In the eleven quarters since the beginning of 1989, real GNP has risen at a compound annual rate of 0.7 percent. If our forecast for next year comes true, average real GNP growth for the four-year period from 1989 through 1992 will be 1 percent — the second slowest four-year period of economic growth since the 1930s. (Real GNP grew by an average annual rate of 0.4 percent from 1979 through 1982.) Even by the consensus estimate for next year, the recovery is expected to be so weak that real GNP will lie further below trend than it did in 1983 following two years of off-and-on recession and one year of recovery.

Things weren't supposed to be this bad. In October 1990 at the onset of recession, the budget agreement was passed by Congress and signed into law by President Bush. Leading up to the vote in July 1990, the Congressional Budget Office stated in its Economic and Budget Outlook:

> CBO projects that enactment of a large and credible multiyear deficit reduction package will bring substantial benifits in the medium term, including stronger economic growth, a lower deficit ..., and higher national wealth and standards of living ... CBO expects that the economy can withstand the short-term restrictive impact of large reductions in the deficit and avoid recession ... CBO's short-term economic forecast for the next eighteen months entails continued moderate growth between 2 percent and 2 1/2 percent .... Spending on business equipment and inventories should respond quickly and strongly following the deficit cuts.

Just a week before the vote, President Bush spoke to the nation on television. He said,

> . . . if we fail to act, next year alone we will face a federal budget deficit of more than $300 billion . . . We must act this week [and vote for] a deficit-reduction agreement worked out between the administration and the bipartisan

Economic Outlook, published quarterly by the Forecasting Section, Chamber of Commerce of the United States of America, provides its readership with the Chamber's official forecast of the U.S. economy. It analyzes the vital issues affecting current economic activity and provides the latest economic trends. Subscription cost is $60.00 per year.

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Dr. Lawrence A. Hunter, Acting Chief Economist
Dr. William K. MacReynolds, Director, Forecasting Section
Merlyn R. Nolan, Economic Analyst

UNITED STATES ECONOMIC OUTLOOK 1991 - 1992

Prepared by the U.S. Chamber of Commerce

Fourth Quarter 1991

(Percent change from previous periods at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS						YEARS				
	Actual	Forecast					Actual			Forecast	
							Annual Average				
	91/3	91/4	92/1	92/2	92/3	92/4	'83-'88	1989	1990	1991	1992
GROSS NATIONAL PRODUCT											
Nominal GNP	4.2	3.4	3.1	4.7	5.5	5.5	7.5	6.7	5.1	3.2	4.2
Real GNP	2.4	-0.2	-0.6	1.9	2.9	2.6	4.0	2.5	1.0	-0.6	1.0
Consumption	3.8	0.5	-1.4	1.7	2.6	2.9	4.1	1.9	0.9	0.3	1.2
Residential Investment	20.6	6.7	-3.2	4.5	4.8	5.6	10.8	-4.1	-5.4	-11.5	4.7
Nonresidential Investment	6.6	-6.3	-0.4	1.2	1.4	3.9	4.8	3.9	1.8	-3.0	0.2
Equipment	17.1	-2.0	0.7	1.8	1.6	4.3	8.5	5.2	2.8	0.1	3.0
Structures	-25.3	-23.5	-5.0	-1.3	0.6	2.1	-2.6	0.0	-1.2	-13.0	-10.1
Exports	0.1	1.9	2.2	3.5	5.4	4.4	6.7	11.0	6.4	3.6	2.8
Real Net Exports (82$B)	-32.8	-35.7	-29.9	-27.7	-26.9	-29.1	-88.7	-54.1	-33.8	-18.5	-28.4
Imports	12.9	3.5	-1.3	2.1	4.7	5.5	10.5	6.0	2.8	1.1	4.2
Government Purchases	-6.6	-3.2	-0.9	-1.3	-0.3	1.9	3.2	2.3	2.8	0.4	-1.7
Final Sales	0.6	-1.1	-0.7	1.4	2.1	2.7	3.8	2.5	1.6	-0.2	0.4
Change in Business Inventories (82$B)	-15.1	-5.8	-4.8	0.6	9.1	7.7	21.6	23.8	-3.6	-19.8	3.2
Industrial Production	6.2	1.0	0.9	2.7	2.9	3.6	4.9	1.7	1.0	-1.8	2.5
New Car Sales (mill.)	8.7	8.6	8.7	9.0	9.1	9.2	10.5	9.9	9.5	8.5	9.0
Domestic Car Sales (mill.)	6.4	6.3	6.3	6.6	6.6	6.8	7.6	7.1	6.9	6.2	6.6
New Housing Starts (mill.)	1.05	1.07	1.10	1.15	1.19	1.24	1.68	1.39	1.20	1.01	1.17
EMPLOYMENT, WAGES AND PRICES											
Civilian Unemployment Rate (%)	6.8	6.9	7.1	7.3	7.2	7.0	7.2	5.3	5.5	6.8	7.1
Compensation	3.5	4.2	4.9	4.7	4.3	4.2	4.3	3.0	3.9	4.4	4.5
Productivity	2.4	1.4	1.1	0.9	1.5	1.1	1.9	-0.3	-0.6	0.4	1.2
Unit Labor Costs	1.1	2.8	3.8	3.8	2.8	3.1	2.3	3.3	4.4	4.0	3.3
Consumer Price Index	3.3	4.4	4.5	3.7	3.8	4.2	3.5	4.6	5.4	4.4	4.0
Implicit GNP Deflator	1.8	3.5	3.7	3.0	2.7	2.9	3.3	4.1	4.1	3.9	3.2
Prime Interest Rate (%)	8.4	8.0	7.8	7.8	8.0	8.3	9.8	10.9	10.1	8.6	8.0
3-mos. Treasury Bill Rate (%)	5.4	4.9	4.8	5.0	5.2	5.4	7.8	8.1	7.5	5.5	5.1
Corporate Bond Rate (%)	8.8	8.5	8.4	8.4	8.6	8.8	10.7	9.3	9.3	8.8	8.6
Real Personal Disposable Income	2.0	1.1	1.5	2.5	3.1	2.1	3.6	2.4	0.9	-0.4	2.0
Changes in Profits from Current Production ($B)1	6.2*	4.3	4.1	1.6	3.4	2.1	29.8	-26.0	-13.4	-10.4	11.6

*Estimated third quarter profits.

1Corporate profits with inventory valuation and capital consumption allowances.

FORECAST ASSUMPTIONS

This forecast table contains advance estimates of the National Income and Product Accounts for the third quarter of 1991. The nation's money supply M(2) is assumed to grow by 3.2 percent in 1991 and by 4.5 percent in 1992. The trade weighted exchange value of the dollar falls by 0.3 percent in 1991 and rises by 1.0 percent in 1992.

SOURCE: U.S. Chamber of Commerce, Forecast Section, using the Washington University macro model of the U.S. economy.

leaders of Congress. This budget agreement is the result of eight months of blood, sweat and fears — fears of the economic chaos that would follow if we fail to reduce the deficit. . . . I am convinced that this agreement will help lower interest rates, and lower interest rates means savings for consumers, lower mortgage payments for new homeowners, and more investment to produce more jobs. And that's what this agreement will do. . . And most of all, it will not let our economy slip out of control.

There are several flaws in the arguments presented in favor of the budget agreement which we pointed out last year, well before the agreement was signed. One obvious flaw was that deficit reduction was implausible if spending restraint was being lifted. Indeed, the agreement replaced the hard-to-achieve Gramm-Rudman-Hollings (GRH) deficit targets with flexible spending caps. Even though the GRH targets were never hit, they placed a severe limit on spending increases when tax increases were ruled out as they were from 1987 to 1989. If the target was missed, a sequester automatically was to go into effect under GRH. It was the fear of a large sequester that propelled the bipartisan leadership to propose the budget agreement. In truth, the agreement was meant to increase spending beyond the strictures of current law and to justify increases in taxes by the new "pay-as-you-go" provision that replaced the old GRH deficit limits.

Another flaw concerned faulty economic reasoning that still persists today. The argument went that deficit reduction was the only way to bring interest rates down, and falling interest rates was the only way to achieve healthy economic growth. Instead, what has happened in the past year is that the economy slowed because of tax increases and other policy mistakes. As a result of the slowdown and recession, interest rates fell. Indeed short-term interest rates were falling even before the Fed belatedly recognized the economy was in trouble. But while interest rates were falling, the budget deficit rose above the near record 1990 amount. At present, interest rates are still falling as the budget deficit is rising to well over $300 billion — a clear record.

As we predicted last July, the recession would cause both falling interest rates and a rising budget deficit. The nonsensical economic scenario offered by proponents of the budget agreement ought to be discarded.

It is interesting to note that CBO budget deficit projections in July 1990 without a budget deficit agreement in hand were below what they are today with the budget deficit agreement in force. The stated intent of the $160 billion of tax increases in the budget agreement compromise was for deficit reduction. To people who don't pay close attention to how Washington counts things, those taxes appear to have evaporated into thin air. Indeed, what happened was that slow economic growth and a recession reduced actual and projected government revenues and caused the deficit to soar. Those "helpful" tax increases, instead of reducing the budget deficit contributed to the decline in GNP and record deficits. Meanwhile, spending is still out of control, and the budget deficit, even with a recovery in 1992, is headed in the wrong direction. The hopes of last October have faded, and policy makers are groping for new solutions.

Alarmed by the state of the economy, a number of legislators, both Democrat and Republican, have proposed various legislation intended to provide middle class tax relief and encourage new economic growth. Senator Lloyd Bentsen (D-TX), for instance, has proposed a $300 tax credit for each child and Individual Retirement Accounts for every American. According to Bentsen, "The tax credit would put money in the pockets of American consumers and help jump-start an economy that is dead in the water. The expanded IRA would encourage savings and investment needed to help sustain growth."

Building on the Bentsen plan is the "Economic Growth and Family Tax Freedom Act" proposed by Senator Bob Kasten and Representative Vin Weber. It's components include: family tax relief providing a $300 nonrefundable tax credit for children between the ages of 6 and 18, and a $1,000 credit for children under the age of 6; a reduction in the capital gains tax to a top rate of 15% for individuals and corporations, and to 7.5% for lower bracket individuals; a Neutral Cost Recovery System; an IRA-Plus plan; repeal of the passive loss limitation for all active participants; and, creation of enterprise zones.

The positive economic impact of such a package would be substantial. According to former Treasury economist Gary Robbins, such a combination of tax incentives would increase the growth of GNP by an average of 1 percentage point per year over the next 5 years, while creating 1.4 million new jobs.

An additional boost to both job creation and middle class tax relief would result from a reduction in Social Security taxes. A 2 percentage point cut in the payroll tax (1 percent each for both workers and employers) has been proposed By Senator Malcolm Wallop and Representatives Tom DeLay and Robin Tallon in the Economic Growth and Jobs Creation Act (S. 381 and H.R. 960).

There are numerous other good ideas that might be added to such a package or substituted in place of one of the above ideas. Regardless of what the specific components are, the final package must be broad based, offering tax relief for families, workers, savers, investors and entrepreneurs. And, it must be aimed at encouraging more productive activity, not just putting more money in everybody's pocket.

But how to pay for the package? On the spending side, Senator Bentsen has suggested reducing defense outlays by approximately $55 billion over the next five years. Senator Jim Sasser has suggested a 6 percent peace dividend that amounts to about $70 billion. In addition to such defense budget savings, an effective economic growth package would generate a permanent economic growth dividend.

The Kasten/Weber package, for instance, would increase GNP growth by an average of 1 percentage point per year over the next 5 years. Given the kinds of proposals currently being proposed on capital hill, it would be possible to improve on this. (The forty-year growth trend is 3.0 percent a year and the recent trend, prior to the onset of the slowdown three years ago, is about 3.3 percent. The average rate of growth during the first year of recovery from a recession is about 5.5 percent. Based on these historical averages, an average annual growth rate of 4 percent a year over the next five years should be a reasonable expectation.) But to be conservative in our estimates, let's assume that we achieve no more than an increase in the annual rate of economic growth from the 2.5 percent average forecasted by the Blue Chip Consensus to 3.5 percent. Such an objective is not unreasonable.

If we set as our objective a one percent increase in the rate of economic growth, the Congressional Budget Office estimates that the increased economic growth alone would reduce the deficit by $258 billion over five years. In other words, by CBO's own estimates, it should be possible to reduce taxes on average by $50 billion a year, spurring new growth and producing more new jobs without increasing the deficit. If we add a $70 billion peace dividend, that means it should be possible to reduce taxes by $328 billion over 5 years, or almost $66 billion a year with no adverse effect on the long-term deficit. A tax package along the lines outlined above falls well within these limits. On a static revenue basis, the total cost of the Kasten/Weber package would be about $202 billion or $40 billion a year —well within the bounds of a modest peace/growth dividend. The remaining $123 billion might fund a scaled-down, 1 percent cut in the Social Security tax, or other tax cuts.

An increase of 1.5 percentage points in the average annual growth rate, to 4 percent growth, could finance even larger tax cuts, without an increase the deficit. Using CBO's rule of thumb, an increase of 1.5 percentage points in the average annual growth rate would generate $387 billion in deficit reduction over 5 years. The full Wallop/DeLay/Tallon FICA rollback would cost $263 billion over 5 years (again, on a static basis). If we succeed in increasing growth by an average of 1.5 percentage points a year, that additional economic growth dividend could be used to fund the full 2 percentage point reduction in Social Security taxes.

Some have argued that tax cuts would be inflationary while others have argued that, like past attempts by Congress to help a sick economy, it would come too late when the economy was already recovering and added stimulus was not needed. However, we anticipate that recovery will be slow. For example, employment will not return to its pre-recession peak until the late summer of 1992 and housing starts will not get back to its pre-recession peak until sometime in 1993.

Moreover, tax cuts, if they do indeed raise production, will serve to keep a damper on inflation. This is what happened during the long expansion from 1983 through 1988. The inflation scare and concern about over-stimulating the economy are what got us into the recession and slow growth problems in the first place. Nonetheless, many policymakers would rather rely on the Fed to get the economy going again.

Against a backdrop of anti-growth tax, spending and regulatory policies, the Fed faces a dilemma. Economic growth is reduced by these policies below what it otherwise would be. By altering growth potential, these policies can make any given Fed policy more inflationary than intended. If the Fed fails to heed declining real GNP growth potential under the weight of anti-growth policies and sets money supply growth consistent with greater-than-achievable increases in economic activity, there will be too much money chasing too few goods, and inflation will flare up.

The problem is, what to do? There is no easy answer. Standard monetary theory holds that price stability will occur when the supply of money matches the demand for money. Since the demand for money rises and falls with real GNP growth, in order to achieve price stability the Fed theoretically should restrain money supply growth as long as anti-growth policies remain in force.

There is, however, a serious risk attached to following this course, especially if the Fed chooses the ill-conceived technique of interest rate manipulation to decelerate the real economy. If the Fed chooses to slow money supply growth in acknowledgement that the economy's growth potential has been reduced by growth-depressing tax, spending and regulatory policies, it runs the risk of recession for which it, rightly or wrongly, will be blamed. The combination of rapid disinflation (or even deflation) and depressing tax, spending and regulatory policies may well prevent timely economic adjustment and result in recession. In this way, the Fed's actions may dramatically affect the short-run oscillations of the real economy about its long-run economic growth path without affecting the long-run path itself. Unfortunately, it is the affects of these short-run dips and spurts that individuals and businesses feel most intensely in their daily lives.

Because the risks are so great, some analysts have concluded that when fiscal and regulatory policies tack significant added costs onto business operations, a modest amount of added inflation may serve as a lubricant to allow relative prices in the economy to adjust as anti-growth policies dislocate production and consumption patterns. If the Fed chooses this course, in effect monetizing these costs, it is imperative that it clearly articulate to markets what it is doing and that it use its lofty vantage point to exhort Congress and the Administration to alter its anti-growth fiscal and regulatory policies. This is the strongest argument in favor of countervailing monetary policy designed to smooth transitions from different rates of economic growth produced by growth-depressing governmental policies. In effect, the argument is that in an economy burdened by anti-growth government policies, some inflation permits a more efficient allocation of resources with minimal economic dislocation.

This option too holds great risks. If the Fed chooses to monetize anti-growth policies, it may spur on Congress and the Administration to further fiscal and regulatory excesses. If so, and if the Fed continues to monetize these costs, inflation soon would get out of control as it did in the late 1970s, and real GNP growth would remain low.

The Fed has made no clear choice, but rather has succumbed to every fear without clearly enunciating what it is doing and why. After allowing the federal funds rate to fall numerous times over the past year, it is clear Fed policy alone is unable to get the economy going. The Fed has supplied ample new bank reserves; however, banks facing difficult economic and regulatory conditions would rather invest these new funds than lend them. Slow money supply growth, rather than inhibiting the recovery, is merely a reflection of misguided banking regulation and poor economic performance. In effect, the Fed has been neutralized. Once the economy begins to grow again, banks will be able to sell some of their newly acquired investments and make new loans.

As long as money supply growth remains under control so that M2 grows by 6 percent or less, nominal GNP growth can be held to no more than 6 percent. Since nominal GNP growth is made up of inflation and real GNP growth, more real GNP growth will provide less inflation. And more real GNP growth is needed now and throughout the 1990s to prevent prolonged periods of stagnant living standards.

A3840-6

ECONOMIC OUTLOOK

Chamber of Commerce of the United States First Quarter 1992

RESILIENCY LOST

As we warned previously, the American economy entered 1992 as it entered 1991 —in recession. Throughout the fourth quarter of last year, major economic indicators pointed to a deteriorating economy; employment fell, unemployment rose, consumer expenditures dropped and industrial production plunged downward. Now, even the Bush Administration acknowledges that the hoped-for recovery has not materialized as promised.

As 1992 begins, Americans are gloomy. Consumer confidence, as measured by the Conference Board's Consumer Confidence Survey, plunged to a recession level of 52.4 in December. According to the U.S. Chamber's Business Ballot for December, the predominant view among business people is that over the first six months of 1992 the economy will continue its decline, sales will fall, and employment will drop. The Chamber's index of over 8,000 respondents' confidence, nearly 60 in June, was at 39.4 in December.

In a dramatic statement before the House Ways and Means Committee on December 18, 1991, Federal Reserve Board Chairman Alan Greenspan characterized the national dyspepsia this way: "There is a deep-seated concern out there, which I must say to you I have not seen in my lifetime. . . . [I]t is very hard to grasp the depth of the concerns unless you look at it as a problem about the future." Noting this dire situation, Greenspan stated at that time that bringing the economy out of recession and into a period of strong recovery could not be accomplished with Fed policy alone.

Indeed, Fed policy has little or no impact on real economic growth over the longer term. Part of the reason for this is the way monetary policy is conducted. During periods of slow economic growth, the Fed traditionally adds money to the credit system to try to bolster economic activity. Invariably the Fed stays on this tack far longer than fundamental economic activity warrants. As a result (and often in panic), the Fed then tries to cut back precipitously on credit growth in an attempt to quell inflationary fears. In its niggardly phase, the Fed also tends to persist for far too long causing enormous havoc in the economy. This back-and-forth Fed policy negates itself and the economy is no better off. The instability caused by stop-go Fed policy arguably makes the economy worse off, subject to far greater uncertainty.

Over the long-term, researchers have found that Fed policy does not affect economic growth. Instead, the empirical evidence shows almost without exception that Fed policy only affects inflation, not jobs and growth in the real economy. Thus, the best we can expect from the Fed at this time is to recognize, as it now clearly does, that the economy is slumping. The Fed should allow interest rates to fall to keep the recession from getting worse and to avoid getting in the way of a recovery.

However, the problem of the economy is not that the current recession is long nor that the recovery is slow to come about. Rather the problem is a deterioration in long-term economic growth. Since the beginning of 1989, the economy has been virtually stagnant resulting in an amount of real Gross Domestic Product that lies far below the amount consistent with postwar trend economic growth.

Consequently, a sizeable growth gap is emerging. This gap is expected to widen throughout the 1990s based upon the Blue Chip consensus of private forecasters. Instead of moving rapidly back to the trend amount of real GDP as in past economic recoveries, the economy is projected to grow slower than the postwar trend of about 3 percent during this decade, or at about 2.5 percent. This seemingly small difference in growth rates adds up to hundreds of billions of dollars in lost output over the course of ten years. Indeed, growth potential estimates from some prominent forecasters are currently falling. Economic growth estimates for the 1990s may soon fall to 2 percent or below.

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							Annual Average				
	91/3	91/4	92/1	92/2	92/3	92/4	'83-'88	1989	1990	1991	1992
GROSS DOMESTIC PRODUCT											
Nominal GDP	4.1	3.4	3.1	4.7	5.5	5.5	7.5	7.0	5.1	3.2	4.2
Real GDP	1.8	-0.2	-0.6	1.9	2.9	2.6	4.0	2.5	1.0	-0.6	1.0
Consumption	2.3	0.5	-1.4	1.7	2.6	2.9	4.1	1.9	1.2	0.3	1.2
Residential Investment	10.9	6.7	-3.2	4.5	4.8	5.6	10.8	-3.3	-8.7	-11.5	4.7
Nonresidential Investment	-3.7	-6.3	-0.4	1.2	1.4	3.9	4.8	2.2	1.2	-3.0	0.2
Equipment	1.6	-2.0	0.7	1.8	1.6	4.3	8.5	2.3	1.6	0.1	3.0
Structures	-6.6	-23.5	-5.0	-1.3	0.6	2.1	-2.6	2.0	0.3	-13.0	-10.1
Exports	7.3	1.9	2.2	3.5	5.4	4.4	6.7	11.3	7.8	3.6	2.8
Real Net Exports (87$B)	-31.1	-35.7	-29.9	-27.7	-26.9	-29.1	-88.7	-75.7	-51.3	-18.5	-28.4
Imports	22.3	3.5	-1.3	2.1	4.7	5.5	10.5	3.7	2.2	1.1	4.2
Government Purchases	-3.4	-3.2	-0.9	-1.3	-0.3	1.9	3.2	1.5	3.2	0.4	-1.7
Final Sales of Domestic Product	-0.7	-1.1	-0.7	1.4	2.1	2.7	3.8	2.2	1.7	-0.2	0.4
Change in Business Inventories (87$B)	0.1	-5.8	-4.8	0.6	9.1	7.7	21.6	32.6	0.2	-19.8	3.2
Industrial Production	6.4	1.0	0.9	2.7	2.9	3.6	4.9	1.7	1.0	-1.8	2.5
New Car Sales (mill.)	8.7	8.4	8.7	9.0	9.1	9.2	10.5	9.9	9.5	8.5	9.0
Domestic Car Sales (mill.)	6.4	6.1	6.3	6.6	6.6	6.8	7.6	7.1	6.9	6.2	6.6
New Housing Starts (mill.)	1.04	1.07	1.10	1.15	1.19	1.24	1.68	1.39	1.20	1.01	1.17
EMPLOYMENT, WAGES AND PRICES											
Civilian Unemployment Rate (%)	6.8	6.9	7.1	7.3	7.2	7.0	7.2	5.3	5.5	6.8	7.1
Compensation	2.7	4.2	4.9	4.7	4.3	4.2	4.3	3.4	5.2	4.4	4.5
Productivity	0.9	1.4	1.1	0.9	1.5	1.1	1.9	-0.9	-0.1	0.4	1.2
Unit Labor Costs	1.9	2.8	3.8	3.8	2.8	3.1	2.3	4.3	5.3	4.0	3.3
Consumer Price Index	3.3	4.4	4.5	3.7	3.8	4.2	3.5	4.6	5.4	4.4	4.0
Implicit GNP Deflator	1.8	3.5	3.7	3.0	2.7	2.9	3.3	4.1	4.1	3.9	3.2
Prime Interest Rate (%)	8.4	7.6	6.4	6.0	6.0	6.5	9.8	10.9	10.1	8.5	6.2
3-mos. Treasury Bill Rate (%)	5.4	4.6	3.9	3.8	4.0	4.2	7.8	8.1	7.5	5.5	4.0
Corporate Bond Rate (%)	8.8	8.4	7.9	7.7	7.7	7.7	10.7	9.3	9.3	8.8	7.7
Real Personal Disposable Income	2.0	1.1	1.5	2.5	3.1	2.1	3.6	2.4	0.9	-0.4	2.0
Changes in Profits from Current Production ($B)1	2.6	4.3	4.1	1.6	3.4	2.1	29.8	-13.3	-32.7	-10.4	11.6

1Corporate profits with inventory valuation and capital consumption allowances.

FORECAST ASSUMPTIONS

This forecast table contains final estimates of the National Income and Product Accounts for the third quarter of 1991. The nation's money supply M(2) is assumed to grow by 4.5 percent in 1992. The trade weighted exchange value of the dollar rises by 1.0 percent in 1992.

SOURCE: U.S. Chamber of Commerce, Forecast Section, using the Washington University macro model of the U.S. economy.

The origins and nature of economic growth remains a mystery to some economists, but there is some refreshing new thinking taking place within the economics profession. These new ideas on the nature of successful economic coordination and growth have also begun to appear in the popular press and policy debates on Capitol Hill. Today, most economists recognize and agree upon the basic requirements of a productive, healthy economy. As an article in the January 4, 1992 issue of *The Economist* notes, economists now agree that some of the components leading to sustained economic growth are measurable and well understood; namely, the efficient employment of capital and labor coupled with incentives to promote the correct use of each factor of production. Obviously, technological discovery and the innovative use of new and existing knowledge also contribute to economic growth. However, the amounts of these variables is, at best, unknown and their contribution to economic growth can only be guessed at.

As we have pointed out before, central to the problem of overcoming low rates of economic growth is the nature of political and legal institutions in which an economy functions. For example, those countries that provide strong and consistent protection of individuals' private property rights tend to grow more rapidly than those that do not. In addition, those countries that minimize interference with free market price determination also experience higher rates of economic growth. It is no wonder that many nations around the world are abandoning failed policies of central authority for market-based systems and the extension of enforceable rights to private property.

Moreover, as *The Economist* points out, the economics profession is beginning to recognize that government fiscal and regulatory policies can greatly affect the potential for long-term economic growth. Since the 1960s in the U.S., the primary use of government policy has been to stabilize economic activity in an attempt to smooth out gyrations in the business cycle. But while policymakers have been attempting to fine-tune the economy according to old counter-cyclical prescriptions, contemporary research has discovered new facts about the nature of long-term growth that conflict with the short-term nostrums of Keynesianism. By focusing almost exclusively on stabilization policies, the U.S. government has tended to ignore, for the most part, those policies that promote economic growth. It has been found that, as government spending increases as a share of the total economy's output, economic growth rates tend to slow. Countries in the world with smaller shares of government spending as a percent of GDP have tended to grow more rapidly.

Over the past two decades, both government spending and regulation have grown faster than the U.S. economy. Despite rising tax revenues throughout the 1980s, the federal government continues to run a persistent, growing budget deficit. And because of the record tax hikes passed in 1990, direct tax burdens continue to increase, as do regulatory "taxes" on businesses forced to comply with costly mandates.

As 1992 begins, falling consumer and producer expectations, while alarming, reflect an accurate snapshot of the general lack of confidence in the long-run performance of the economy. Beneath the surface of this uniformly gloomy outlook, however, there are two distinctly different sources of discontent. On the one hand, there are those who suffer from a real sense of melancholy regarding America's future. These individuals suffer from a profound pessimism and fear that our nation is in decline. From this perspective, the current cyclical downturn merely magnifies much more serious structural problems that go to the very heart of the American free enterprise system.

The second source of discontent has nothing to do with the fundamentals of the American free enterprise system or with American businesses' capabilities. The source of pessimism is not rooted in a concern over the fundamental health of the American private enterprise system, but rather with government. The pessimism among individuals in this camp springs from a pessimism about governments and their proclivity to do the wrong thing and their apparent inability or unwillingness to do the correct thing.

We find ourselves in the latter camp. The 1990s will be a dismal decade unless fundamental policy changes are put in place to unleash the productive genius of American business and workers. The reason our economic outlook is dismal is not because there is something fundamentally wrong with the American economy nor American business per se. Historically, American enterprise has demonstrated a remarkable ability to function under the seemingly insurmountable burden placed on it by the public sector and ill-conceived public policy decisions. But there are limits to that resiliency.

Federal spending on its programs and federal regulation of business are viewed by program and regulation proponents as exceedingly helpful to the economy. Proponents argue successfully to expand their favored programs by citing the alleged benefits. When government attempts to pay for these programs directly, the impact on the economy can be dramatic. For example, The 1986 Tax Reform Act greatly reduced the return to businesses' capital investment. The economy has since lost approximately $300 billion in growth-creating investments in the private sector. More specifically, by raising the cost of capital, government policy has discouraged the formation of new businesses by making investment too costly and less rewarding.

When the economy is growing at a healthy rate, entrepreneurial spirits are generally very high. Although new businesses continue to fail and mature businesses seek to restructure, under policies that keep the cost of capital low, new business growth more than compensates for the losses of jobs and output resulting from failing and stagnant enterprises. As a result, overall business and consumer confidence remains high even though major restructuring

and normal business mistakes are causing certain sectors and areas of the country to contract. In a market economy, resiliency is not assured by government-managed stability, but by the prospects for and pursuit of new opportunities according to new discoveries and shifting consumer demands.

The problem is not market failure, but rather the failure of government policies. What the federal government must do now to promote long-term growth is reduce, and eliminate where possible, the burdens of past policy mistakes on market processes.

The goals of such a comprehensive strategy for economic growth and opportunity should be to raise economic growth to 4 percent for the remainder of the 1990s and to enhance long-term growth potential to at least 3 percent, the postwar average.

A coordinated set of actions by the federal government involving tax changes, regulatory relief, spending restraint, and measures to bolster the financial system should be implemented to correct the course of the economy. Key building blocks of the new foundation consist of a capital gains tax cut to reward investment and raise asset values, reform of the capital cost recovery system to permit full and quicker write-offs of investment in plant and equipment, reform of the Alternative Minimum Tax to eliminate the disincentives to invest, permanent reenactment of key expiring tax provisions, payroll tax relief and reinstatement and expansion of Individual Retirement Accounts.

These tax changes should be accompanied by budget changes to bring federal spending in line with revenues. Spending must be reduced from 25 percent of GDP — a peacetime high — to rates far more conducive to stronger economic growth. If tax cuts are enacted part of the work will be done. That is to say, tax cuts will spur more GDP growth. However, current federal spending is three years ahead of projected federal revenues. To move quickly to get spending in line with what the economy can afford, discretionary spending can be "frozen" at 1992 levels for a few years or held quite a bit below projected increases in economic growth. This is relatively easy to accomplish since $150 billion can be cut from defense spending over the next five years.

Another way to contain federal spending growth is to cut waste. This is easy to say, but difficult to do. As P. J. O'Rourke has observed in *Parliament of Whores* about our government, "It takes enormous effort and elaborate planning to waste this much money." Waste can be cut if federal spending is shifted away from purely consumption activities into investments. Over the long-term, the federal government must cut the growth in the fastest growing programs. Accordingly, a commission to reform entitlement spending, especially in Social Security and Medicare, should be established to alleviate the increasing burden on unaffordable future federal expenditures.

Until economic growth targets are reached, the federal government should adopt a moratorium on new regulations and create a sound process for evaluating regulations in the future. In 1992 alone, regulations that will cost business approximately $70 billion to comply with are already in the pipeline. Halting their implementation and requiring an economic growth impact statement for these and all future regulations would improve the prospects for long-term economic growth. In addition, the federal government should allow business immediate expensing for any capital investment necessitated by mandated actions to meet current and future regulatory requirements.

By way of expanding government investment, the federal government should enact a highway and airport/airway infrastructure bill to repair and expand specific components of the nation's transportation infrastructure where required to improve the overall productivity of the economy. The money for infrastructure improvements is available without having to increase taxes. The Airport and Airways Trust Fund has an uncommitted surplus of some $8 billion that is currently being used to fund other federal government programs. The Highway Trust Fund balance is approaching $16 billion. Currently, the annual increase in this fund is $2 billion.

While this comprehensive strategy contains sensible policy prescriptions to promote long-term economic growth, opposition to such a plan is widespread. Many legislators believe that the economy would be better off with higher taxes, more regulations and more federal spending. Some want to use the potential "savings" in defense spending to bolster domestic programs related to health, poverty and the nation's infrastructure — including education. In the process, these same legislators want to cut middle income taxes temporarily to help the economy by raising the budget deficit. In essence, while these legislators bemoan slow economic growth and blame the Bush administration for poor economic performance, they are unwilling to do anything to build up the long-term strength of the economy.

We are not optimistic about the outcome of the political battle over economic policy this year. The pro-growth push that resulted in the only across-the-board tax cut in ten years in 1981, took three years to gain steam and political support. It also had the benefit of strong leadership in the 1981 Congress and from the Reagan administration. Such leadership is not to be seen in 1992.

Thus, we believe the economy will grow by just 1 percent in 1992 and by only 2 percent in 1993 before it settles back to an average of about 1.8 percent for the remainder of the decade. If this forecast for the economy is correct, the federal budget deficit will rise to over $500 billion by 1995 and everyone will wonder again what to do about the deficit. Business and consumer confidence will remain low because they will have lost total confidence in the ability of government to live within its means.

M3840-6

ECONOMIC OUTLOOK

Chamber of Commerce of the United States

Second Quarter 1992

THE LONG RECESSION IS OVER: NOW WHAT?

After a false start last Spring, we believe the evidence will show that an economic turning point finally occurred in February 1992. If January is eventually judged to be the last month of recession, it will have lasted 19 months.

As measured by declines in employment and the government's index of coincident indicators, the economy first headed downward in July 1990. Although it showed some signs of gaining life in the second and third quarters of 1991, the movement upward was not decisive in strength nor sustainable in direction.

Both employment and the coincident indicators rose sharply in February. The February turnaround, although a month earlier than we anticipated, is consistent with our long-standing forecast. All told, our forecast for the first half of 1992 has not changed — an annual rate of growth of 0.7 percent. What has changed is that the weak first quarter will appear stronger than it actually is and the second quarter will barely match the first both due to seasonal adjustment factors heavily influenced by war. Thus, we have revised our first quarter up to a 0.6 percent annualized gain and the second quarter down to just a 0.8 percent gain.

The upward revision of the first quarter is due entirely to misleading seasonal adjustment factors. Data reported during the first quarter of 1991 were heavily influenced by the war in the Middle East. This year, certain seasonally adjusted data — in particular, retail sales, consumer confidence, personal income and consumption — will appear far more positive than is actually the case. The war in 1991 has had the effect of inflating reported 1992 gains during January and February because the decline in consumer activity caused by the war is now built in to 1992 seasonal adjustment factors. Thus, flat or even declining retail sales in early 1992 will be propped up by outsized seasonal adjustment factors creating apparently substantial gains where, perhaps, none or weak gains actually exist. Instead of falling, reported real GDP will rise slightly in the first quarter.

The postwar euphoria experienced during the second quarter of 1991 will have just the opposite effect on second quarter 1992 data. Seasonal adjustment factors will dampen the improvement in the second quarter of this year. Instead of a negative first quarter followed by a sizeable second quarter real GDP gain, the second quarter will not look much stronger than the first. Without the vagaries of seasonal adjustment, quarterly GDP reports would have unmistakably shown that the economy slipped a little at the beginning of 1992 and that a recovery was well on the way by the second quarter of 1992.

It won't be unambiguously clear in statistical reports that a recovery is clearly taking place until after midyear. The term recovery has a special meaning: The first year of recoveries traditionally (read always) entail faster economic growth than the year just prior to recession. Revised GDP numbers show that the economy grew by 1.2 percent during the year just prior to the onset of recession that first showed up in the fourth quarter of 1990.

Even though the economy as measured by quarterly changes in GDP stopped falling early in 1991, economic growth has not yet risen above 1.2 percent for a sustained period of time. In the last six months of 1991, the economy grew by an annual rate of 1.1 percent. It will not be until the last half of 1992, when we project real GDP will grow by an annual rate of approximately 1.9 percent, that reports will show that the economy is growing above the growth it experienced just prior to recession.

The term used most often to describe the pace of economic growth for the past year is "sluggish." The clearest meaning of this term is that the vestiges of recession remain in place and that a "normal" recovery has not yet begun. Indeed, pieces of evidence from businesses and anecdotal

Economic Outlook, published quarterly by the Forecasting Section, Chamber of Commerce of the United States of America, provides its readership with the Chamber's official forecast of the U.S. economy. It analyzes the vital issues affecting current economic activity and provides the latest economic trends. Subscription cost is $60.00 per year.

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Dr. Lawrence A. Hunter, Vice President and Chief Economist
Dr. William K. MacReynolds, Director, Forecasting Section
Merlyn R. Nolan, Economic Specialist

UNITED STATES ECONOMIC OUTLOOK 1992-93

Prepared by the U.S. Chamber of Commerce

Second Quarter 1992

(Percent change from previous periods at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS						YEARS				
	Actual		Forecast				Actual			Forecast	
							Annual Average				
	91/3	91/4	92/1	92/2	92/3	92/4	'83-'88	1990	1991	1992	1993
GROSS DOMESTIC PRODUCT											
Nominal GDP	4.1	2.2	3.1	3.8	4.5	4.8	7.5	5.1	2.9	3.6	4.9
Real GDP	1.8	0.4	0.6	0.8	1.9	1.8	4.0	1.0	-0.7	1.0	1.8
Consumption	2.3	0.0	4.1	0.3	1.9	1.9	4.1	1.2	-0.2	1.8	1.7
Residential Investment	10.9	12.3	7.7	8.1	4.8	7.6	10.8	-8.7	-10.4	8.5	6.1
Nonresidential Investment	-3.7	-3.4	-5.3	1.2	1.4	5.1	4.8	1.2	-6.6	-1.9	4.1
Equipment	6.7	-1.6	-5.0	2.0	1.8	5.6	8.5	1.6	-3.4	0.2	4.5
Structures	-23.9	-7.8	-6.1	-0.8	0.4	3.9	-2.6	0.3	-13.4	-6.9	2.9
Exports	7.3	9.7	1.0	2.1	5.4	4.4	6.7	7.8	6.3	5.4	4.9
Real Net Exports (87$B)	-31.1	-21.3	-22.8	-25.5	-24.7	-26.6	-88.7	-51.3	-20.9	-24.9	-26.2
Imports	22.3	2.1	2.0	3.9	4.6	5.5	10.5	2.2	0.3	5.9	4.9
Government Purchases	-3.4	-5.4	0.3	-2.4	-0.7	-1.2	3.2	3.2	0.9	-2.0	-1.5
Final Sales of Domestic Product	-0.7	-0.2	2.4	0.0	1.6	1.7	3.8	1.7	-0.5	0.9	1.5
Change in Business Inventories (87$B)	0.1	7.6	-14.6	-4.3	0.0	0.9	21.6	0.2	-13.9	-4.5	10.1
Industrial Production	6.6	-0.5	-1.0	2.7	2.9	3.6	4.9	1.0	-1.9	1.4	2.7
New Car Sales (mill.)	8.6	8.2	8.1	8.5	8.6	8.8	10.5	9.5	8.5	8.6	9.1
Domestic Car Sales (mill.)	6.3	6.1	6.0	6.2	6.4	6.5	7.6	6.9	6.1	6.3	6.8
New Housing Starts (mill.)	1.04	1.09	1.10	1.15	1.19	1.24	1.68	1.20	1.01	1.17	1.37
EMPLOYMENT, WAGES AND PRICES											
Civilian Unemployment Rate (%)	6.8	7.0	7.2	7.4	7.3	7.2	7.2	5.5	6.8	7.3	7.1
Compensation	2.6	2.7	3.6	3.2	3.7	3.8	4.3	5.2	4.0	3.4	4.0
Productivity	0.9	1.7	1.0	0.3	1.3	1.1	1.9	-0.1	0.3	1.1	1.1
Unit Labor Costs	1.8	0.9	2.6	2.9	2.4	2.7	2.3	5.3	3.7	2.2	3.0
Consumer Price Index	3.0	3.2	4.1	3.7	3.8	4.2	3.5	5.4	4.2	3.6	4.3
Implicit GNP Deflator	1.9	2.0	2.5	3.0	2.5	3.1	3.3	4.1	3.6	2.5	3.1
Prime Interest Rate (%)	8.4	7.6	6.5	6.5	6.5	6.5	9.8	10.1	8.5	6.5	6.8
3-mos. Treasury Bill Rate (%)	5.4	4.5	3.9	3.9	3.8	4.3	7.8	7.5	5.4	4.0	4.6
Corporate Bond Rate (%)	8.8	8.5	8.3	8.1	7.9	7.7	10.7	9.3	8.8	8.0	7.8
Real Personal Disposable Income	2.0	0.9	1.5	1.2	3.1	2.1	3.6	0.9	-0.2	1.6	2.2
Changes in Profits from Current Production ($B)1	2.6	4.3	4.1	1.6	3.4	2.1	29.8	-32.7	-11.9	17.1	4.3

1Corporate profits with inventory valuation and capital consumption allowances.

FORECAST ASSUMPTIONS

This forecast table contains final estimates of the National Income and Product Accounts for the fourth quarter of 1991. The nation's money supply M(2) is assumed to grow by 4.5 percent in 1992 and 5.3 percent in 1993. The trade weighted exchange value of the dollar rises by 1.9 percent in 1992 and 1993.

SOURCE: U.S. Chamber of Commerce, Forecast Section.

evidence from individuals last year regarding the painfully slow pace of economic improvement have been the best indicator of the broad economic forces at work.

One piece of evidence comes from a bi-monthly Chamber poll on the business outlook for the upcoming six months. We have developed a Business Confidence Index — a combined poll score of individual business's view of their own sales and employment outlook, and their view of the overall economy's outlook — that is compiled from responses to the Chamber's "Business Ballot." During the recession, the Business Confidence Index for February 1991 was 45.0 where a score above 50 indicates a positive outlook. It rose to 59.4 in June 1991, but then fell in subsequent polls to a low of 39.3 in December 1991. The substantial jump in the Business Confidence Index to 59.1 in February 1992, indicating that the economy should grow in the next six months, was vital in influencing our view that a turnaround occurred in February.

For the past two years, our forecast of economic growth has been extremely accurate. The difference in our forecast from that of most other analyst's has been our recognition of policy mistakes and our estimates of slow nominal growth in GDP. Because of an extremely strong relationship between nominal GDP growth and M2 growth, we have been able to accurately forecast the decline in nominal GDP or demand growth over the past several years. Clearly, in the presence of persistent inflation, declining nominal GDP growth allows little room for real GDP growth.

On a fourth quarter over fourth quarter basis, our forecast for each year was for a 0.1 percent increase in real Gross Domestic Product. We overestimated the actual growth in real GDP by 0.2 percent in 1990 and underestimated it by 0.2 percent in 1991. We anticipate growth of only 1.3 percent in 1992 followed by an increase of just 1.6 percent in 1993 — well below the consensus forecast of 2.5 percent and 3.0 percent, respectively. Translated into rates of growth on a year over year basis as in our forecast table, our forecast calls for growth rates of 1.0 percent and 1.8 percent for 1992 and 1993, respectively. By either method of reporting yearly growth forecasts, the economy will fare better in 1992-3 than it did during the previous two years, 1.4 percent average annual growth versus 0.1 percent.

This slow growth rate during recovery is considerably below the historical average for recoveries. However, contrary to what most analysts say, it is not abnormally low. While the economy always has grown faster during the first year of recovery than it did in the year just prior to the onset of recession, except for one postwar recovery, the economy does not grow by more than twice the rate it entered recession. Hence, a growth rate of 2.4 percent for the first year of recovery is likely to be the best we can expect this time around. The historical average recovery of 5 to 6 percent growth is not the appropriate mark for this recovery because growth before the recession started was far below what it was prior to other postwar recessions.

A word of caution is appropriate. Positive, quarterly annualized growth rates of below 2 percent lasting for more than a year have historically been followed by quarters of negative growth. Indeed, real GDP fell in the fourth quarter of 1990 and the first quarter of 1991 after six consecutive quarters of positive growth below 2 percent. Growth has been positive, but below 2 percent for each quarter since early 1991. Without aberrant seasonal adjustment factors, real GDP would have fallen in the first quarter of this year continuing the historical pattern of unsustainable slow growth.

While we believe there are no negative quarters to come in the near future, we fear the budding recovery will not portend an economic expansion. All but the very most optimistic private forecasters do not expect the economy to grow above its postwar trend of 3 percent for the next few years. The consensus of Blue Chip Economic Forecasters is for growth rates at, or slightly above, the trend rate for just a few quarters beginning in late 1992. At that time, real GDP will be only 92 percent of the level it would have been had the economy continued to grow at its trend rate. To bring the economy back to its full potential, an amount last reached in late 1988, and to close the growth gap completely, the economy would have to expand by well over 3 percent for several years.

We do not expect this growth gap to be closed and, hence, there will be no expansion. The consensus forecast and forecasts by official Washington do not see the growth gap closed either. If no policy actions are taken, the economy will be subject to future bouts of recession, sluggish growth and anemic recovery accompanied by unemployment rates that are typical of below average growth periods in the postwar U.S. economy.

Clearly, policy makers demonstrate little interest in improving the likelihood of more robust economic growth. We believe the marked change in economic growth from somewhat above trend during the period 1983 through 1988 to well below trend since then was largely policy induced, as we have stated many times. Many analysts believed the economy needed to slow down and come in for a soft-landing — about 2 percent real growth with subdued inflation — after the soaring expansion of the 1980s. Fed policy to slow credit growth was seen as the remedy for an "overheating" economy in 1988. But restrictive credit policy along with anti-growth spending, tax and regulatory policies have made the economy
lifeless. The soft-landing never materialized because all federal policies were so strongly anti-growth the economy could not avoid recession.

Over-optimistic forecasts for 1992 and 1993 stem from the fact that many forecasters continue to anticipate

growth in nominal GDP that is too high. As an upper limit, nominal GDP in 1992 could rise by as much as $240 billion or by 4 percent. This limit could only be reached if M2 growth begins to pick up from rates of growth near 3 percent to sustainable rates of growth near 5 percent. Approximately $110 billion of this new demand will be used to pay for new state, federal and local taxes and economy-wide compliance with new regulatory costs. By definition, all of these new costs of government will go to inflation, not real GDP growth. If the remaining amount of new demand is split between inflation and real growth, real GDP will rise by approximately 1 percent in 1992 or $55 billion in constant 1987 dollars.

The lack of official concern over addressing both short-term and longer-term economic problems prompted the Chamber to hold a conference on "What Federal Policies Work to Raise Long-Term Economic Growth?" in January 1992. Four prominent economists presented their views. In summary, the consensus opinion was that a combination of federal policies would work to raise long-term economic growth by 1 percentage point per year. This is an enormous amount of economic activity. It amounts to well over $3 trillion in enhanced real GDP over 10 years. Copies of the conference report are available upon request.

The remedies to below trend growth in these studies focused on reducing the cost of capital so as to improve the long-term benefits of investment and productivity growth. Only one of the prominent researchers could be described as a supply-side economist concerned primarily with incentives to produce, save, work and invest. However, when looking at the long-term, all the researchers became supply-side oriented. All of them also found that significant enhancement of long-term economic growth could only be accomplished with a package of policy changes including improved depreciation or the economic equivalent of expensing, savings incentives and cuts in the capital gains tax. That is, only a combination of reinforcing pro-growth policies would help improve poor growth performance by reversing what we view as the cause of our economic malaise — reinforcing anti-growth policies.

Yet policies designed to improve long-term economic growth have little chance of being enacted this year in Congress. After all, this is an election year and political posturing is far more important than careful policy making. There is precious little leadership on the growth issue. Democrats and Republicans are more interested in trying to emphasize the divisions that exist on economic policy rather than coming to unifying positions. In making these divisions clear, however, each side is distorting reality to such an extent that facts no longer bear upon political debate.

Candidates and party leaders should keep the facts in mind. Some Democrats have observed that during the entire Reagan-Bush years the economy did not grow and jobs were lost. This has been the case only for the past three years. From 1983 through 1988, the economy grew by approximately 4 percent per year. From the depths of the recession in 1981 to the end of 1989, 20 million new jobs were created. Just because the economy has not grown recently does not permit an exaggerated claim that growth stopped when Republicans took the Oval Office.

A corollary of this argument holds that only the rich got richer during the 1980s while the poor suffered. However, from the depths of the recession in 1981 to the end of 1989, all income classes received higher income ranging from a 11 percent gain for the lowest quintile to a 20 percent gain in the highest quintile. The point should not be that the changes in income tax rates during the 1980s created unfairness, but that without economic growth only the rich get richer as happened in the late 1970s.

On the other hand, some Republicans claim that the economy is fine the way it is, that a nice recovery will bring back prosperity. They can abide tax, spending and regulatory increases already placed into law for this year and for the future because they have a rosy outlook. While more economic growth than currently anticipated will be welcome, there is no significant action by the administration to provide the necessary incentives to increase economic growth. Even if the more optimistic consensus of private forecasters is correct, the years 1989 through 1992 will witness the second slowest four years of growth since the 1930s. By its own estimates the administration's tax plan introduced and defeated in Congress earlier this year would have raised economic growth only slightly over the next few years.

Researchers Gary and Aldona Robbins analyzed the growth plans offered by Congressional Democrats and the administration. They found that over the next ten years the Congressional plan would reduce economic growth. The administration plan would raise economic growth and employment and increase the capital stock. The administration plan would add 617,000 jobs by the year 2000. In addition, the Robbins' looked at Jerry Brown's flat tax proposal. It is interesting to note that candidate Brown's flat tax plan would add to GDP and jobs at approximately five times the rate of the administration's tax plan.

Since the economy is currently showing some signs of life, the urgency to deal with recession and its aftermath are waning. This is welcome news to many people who think that politicians are prone to doing the wrong things at the wrong time. However, the future for the economy is fairly well understood — below trend growth for as far as the eye can see. Doing nothing is clearly not enough. Concerted efforts must be made to focus government policy making on improving long-term economic growth. Risky as this may be, there is no time like the present to start the process.

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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

Third Quarter 1992

IS THE RECOVERY WILTING?

For the past three years, economic growth has been below the annual trend rate, approximately 3.1 percent, established since the late 1950s. Since the first quarter of 1989, no quarter has exceeded or matched that trend rate. Only two quarters have shown growth above 2 percent. One by one, previously optimistic analysts are discovering that this recovery is lackluster. Fewer and fewer forecasters now foresee a sizeable pick-up in economic activity.

Revised GDP statistics show that the recession began in the third quarter of 1990 lasting three full quarters instead of two, as previously reported. Real GDP has grown each quarter since the recession ended. It grew at an annual rate of about 1 percent during the last half of 1991 and about 2 percent over the first half of 1992. Like many other forecasters, we predict close to a 3 percent annualized rate of growth during the last half of 1992. However, instead of holding near 3 percent for next year, as the consensus of Blue Chip forecasters suggests, we foresee the economy dropping back toward 2 percent growth as 1993 proceeds. The recovery appears to be wilting not blossoming.

Spurred by Fed action in early July to dramatically cut interest rates once again, the third quarter of 1992 has probably gotten off to a good start compared to the second quarter. Real GDP should grow by 2.7 percent in the current quarter, not quite as fast as the first quarter. The short-term risk to our forecast is for the fourth quarter of 1992, and the risk is clearly on the down side.

The problem with the recovery thus far is that it is uneven. The economy has not yet experienced two consecutive quarters of solid growth. Indeed, other than the three quarters of recession, sluggish growth has been the state of economic affairs since 1989. The Fed has attempted to keep the economy growing, dropping interest rates over twenty times in the past two years. Short-term Treasury rates are now at twenty-nine year lows. Long-term rates are dropping toward 7 percent. If the economy again shows any signs of faltering in September or October, we anticipate the Fed will make another dramatic cut in interest rates.

What Fed action to reduce interest rates accomplishes is to quickly raise asset values. This causes a spurt of buying and selling releasing funds asset sellers want to use to make purchases. However, this is a one-time increase in wealth. Spending increases will only come in short spurts, as happened in January 1992 and as will likely happen again in July and August. If interest rate cuts are going to contribute to an increase in the rate of economic growth permanently, businesses and individuals must be willing to take advantage of lower rates to borrow and invest.

Obviously, nothing like that is occurring. Consumers are busy paying back debt as are businesses. Lower interest rates have generated an enormous increase in business and mortgage refinancing but have not led to new loans for new homes and new investments. Banks, which are still major business lenders, are cutting back on new commercial and industrial loans. At low rates of economic growth, only the few "worthy" credit demands are met.

Most of the new funds injected into the banking system by the Fed are going to the purchase of safe Treasury securities thus supporting federal spending, but not new private spending. Instead of staying in the private sector where new funds multiply into increased economic activity, new funds are dropped into federal security markets which add very little to total private demand. However, lower interest rates are a double-edged sword. Falling interest rates have directly curtailed spending by a growing portion of the population that is living off of fixed income securities.

In testimony by Chairman Alan Greenspan and recent reports on conditions from all districts of the Fed, there is mounting evidence that the recovery is stuck in low gear. Greenspan posited another in a series of hapless explanations about why the economy is so sluggish. He suggested that consumers and businesses are busy paying down the "excessive debt" they accumulated during the

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Dr. Lawrence A. Hunter, Vice President & Chief Economist
Dr. William K. MacReynolds, Director Economic Policy Center

UNITED STATES ECONOMIC OUTLOOK 1992-93
Prepared by the U.S. Chamber of Commerce
Third Quarter 1992

(Percent change from previous periods at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS						Years				
	Actual		Forecast				Actual			Forecast	
							Annual Average				
	92/1	92/2	92/3	92/4	93/1	93/2	'83-'88	1990	1991	1992	1993
GROSS DOMESTIC PRODUCT											
Nominal GDP	6.2	3.7	4.8	4.8	5.6	5.2	7.5	5.2	2.8	4.5	5.1
Real GDP	2.9	1.4	2.7	2.9	2.5	2.3	4.0	0.8	-1.2	1.9	2.4
Consumption	5.1	-0.3	2.7	3.0	2.2	2.1	4.1	1.2	-0.6	2.0	2.2
Residential Investment	20.1	8.7	2.0	4.8	6.6	4.5	10.8	-9.1	-12.6	11.4	5.2
Nonresidential Investment	3.0	13.5	1.4	5.1	5.9	4.0	4.8	-0.4	-7.0	2.0	5.1
Equipment	3.2	20.7	2.5	7.6	8.3	8.9	8.5	-1.0	-4.6	5.6	8.1
Structures	2.7	-2.1	-1.4	-1.0	-0.1	-8.7	-2.6	0.9	-12.0	-5.8	-2.2
Real Net Exports ('87$B)	-21.4	-35.9	-39.1	-38.2	-35.4	-35.7	-88.7	-51.8	-21.6	-33.7	-34.6
Exports	2.9	-3.8	2.6	6.5	5.6	4.6	6.7	8.1	5.8	4.8	4.6
Imports	3.5	6.3	4.6	5.5	3.4	4.5	10.5	3.0	-0.1	6.8	4.5
Government Purchases	1.7	0.3	-0.7	-2.0	2.9	-1.1	3.2	2.8	1.2	-0.6	0.0
Change in Business Inventories ('87$B)	-12.6	1.0	13.9	19.8	12.0	18.5	21.6	6.2	-9.3	5.5	16.7
Final Sales of Domestic Product	4.6	0.3	1.6	2.4	3.1	1.8	3.8	1.3	-0.8	1.6	2.2
EMPLOYMENT, PRODUCTION, PROFITS, INTEREST RATES, INCOME AND PRICES.											
Civilian Unemployment Rate (%)	7.2	7.3	7.8	7.6	7.5	7.4	7.2	5.5	6.8	7.5	7.3
Industrial Production	-2.9	4.5	2.9	3.6	3.0	1.1	4.9	1.0	-1.9	1.5	2.7
New Car Sales (mill.)	8.1	8.5	8.7	8.8	8.7	8.9	10.5	9.5	8.5	8.5	9.0
Domestic Car Sales (mill.)	6.0	6.3	6.5	6.6	6.5	6.7	7.6	6.9	6.1	6.3	6.8
New Housing Starts (mill.)	1.26	1.15	1.22	1.24	1.28	1.31	1.68	1.20	1.01	1.22	1.33
Compensation	3.9	2.7	3.7	3.8	4.2	4.4	4.3	5.4	4.7	3.6	4.0
Productivity	3.8	2.3	3.6	2.1	2.7	1.5	1.9	0.0	0.1	2.8	2.2
Unit Labor Costs	0.1	0.3	0.1	1.7	1.5	2.9	2.3	5.4	4.5	0.8	1.8
Consumer Price Index	2.8	3.5	3.0	3.7	3.2	4.1	3.5	5.4	4.3	3.2	3.6
Implicit GNP Deflator	3.1	2.4	2.3	2.0	2.9	3.0	3.3	4.3	4.0	2.6	2.7
Prime Interest Rate (%)	6.5	6.5	6.0	6.0	6.0	6.2	9.8	10.1	8.5	6.2	6.2
3-mos.Treasury Bill Rate(%)	3.9	3.7	3.2	3.2	3.4	3.6	7.8	7.5	5.4	3.5	3.7
Corporate Bond Rate (%)	8.3	8.3	8.1	8.0	7.9	7.8	10.7	9.3	8.8	8.2	7.8
Real Personal Disposable Income	3.8	2.6	2.9	1.6	2.6	2.0	3.6	0.9	-0.2	2.4	2.1
Changes in Profits from Current Production ($B)1	36.9	1.6	3.4	2.1	-3.2	1.0	29.8	-1.1	-15.4	41.1	4.3

1Corporate profits with inventory valuation and capital consumption allowances.

FORECAST ASSUMPTIONS

This forecast table contains advance estimates of the National Income and Product Accounts for the third quarter of 1992. The nation's money supply M(2) is assumed to grow by 3.5 percent in 1992 and 5.3 percent in 1993. The trade weighted exchange value of the dollar falls by 1.9 percent in 1992 rises by 1.0 percent in 1993.

SOURCE: U.S. Chamber of Commerce, Forecast Section.

expansion of the 1980s. He predicted that when this process runs its course and balance sheets are expunged of unwieldy amounts of debt, the economy will take off.

While there are some intriguing elements to this explanation, it does not hold water. If borrowers are busy paying off debts the question is what is happening to the repaid funds? If good investment opportunities exist, these funds would re-enter the private sector to support new investments. At present, the yield spread between private sector and public sector rates is growing. Low Treasury security interest rates relative to market rates for private investments are a clear indication that attractive alternative investments are becoming rarer. For if they were plentiful, the private-public rate spread would be far narrower.

It is important to note that at all times, good and bad, debts are being repaid. In a well-functioning economy, debts are paid on time or gladly extended. When the economy is growing with vigor, new private debt growth exceeds the rate of repayment leading, on net, to produce significant increases in private debt.

Sometimes, as during the expansion of the 1980s, the net increase in debt is greater than current income growth resulting in a rising debt burden relative to income. However, during that same period private asset values rose even faster than liabilities creating large increases in private net worth. Asset values rose rapidly because markets expected improvements in future income flows. The singular focus by Greenspan and others on the liability side completely ignores the real problem the economy is facing — asset values are stagnant or falling and there is a paucity of new investment opportunities.

Unless underlying problems that inhibit economic growth are addressed, the recovery will continue to be weak. Moreover, the weak recovery will guarantee a high degree of vulnerability to future recessions. It will take little more than an ill-advised tax increase, a new oil crisis, a recession in a foreign country that trades heavily with the U.S., a financial crash perhaps limited to one large bank failure, or another all-encompassing piece of legislation like the Americans With Disabilities Act that imposes immediate large compliance costs on businesses, to turn feeble, uneven growth into stagnation or recession.

Since people are able and willing to pay off debt, the economy clearly does not suffer from a liquidity problem. These repaid funds first drop into the private sector available for new lending. Yet, these funds leave the private sector because there are few profitable places to invest them. The central ingredient for sustained growth is missing — entrepreneurial spirits.

Unless many people are excited about the future, have the inclination to devote their savings to a new venture, are capable of organizing other investors and can successfully seek additional credit, and are ready to set out to "build a better mousetrap," the only investments available are in the larger, well-established businesses or government. But the larger businesses are trying to eke out productivity and profit increases while at the same time cutting back on permanent employees. The net effect of their actions on the economy are only slightly positive. And the loans to fund bigger government are economically counter-productive.

To overcome the typically large failure rate of new businesses, the incentives to invest in new ventures must be extremely strong. Unfortunately, stifling, anti-growth policies of recent years are still in place. New and existing small businesses have been hardest hit by tax and regulatory increases. In addition, small businesses are suffering more than larger concerns from growing regulation of the banking industry. The prolonged credit crunch had its origins in bad tax policies and Fed high interest rate policy and has been exacerbated by a punishing set of new rules and regulations on depository institutions.

It will not be enough to delay implementation of these new banking regulations to break the back of the credit crunch. To encourage banks to make loans on decent terms to small businesses will take wholesale changes. Banking laws and the political environment causing such pernicious laws to be passed in the first place must reverse directions. Banks now hold more assets in safe Treasury securities than in private loans for the first time since the 1950s. The major reason is that banks are striving to meet new regulatory standards on capital. Consequently, small businesses now face a situation where they must raise all the capital needed to start a new enterprise or find new types of lenders. Putting equity and debt together is the secret to financing robust economic growth. As new loans shift away from traditional sources — banks — small businesses must expend funds to cultivate new and ready sources of funds.

Some small businesses are successful in finding loans from non-banks. However, loans from any source are hard to come by because the future profitability of new businesses has been damaged by higher taxes and growing regulation and the threat that more is on the way. These new costs come directly out of employee compensation and profits. An average dollar of business sales is split so that 43.7 cents goes to labor, 43.6 cents to government for taxes, 9 cents to depreciation and only 3.7 cents to investors. Increased regulation results in reduced productivity because workers must spend time complying with new regulations and not in servicing customers. Complying with new regulations directly lowers productivity increases.

It has been estimated by researchers at the New York Federal Reserve that the investment tax incentives put into law in the early 1980s have been totally reversed. The bulk of the economic growth that occurred during the last half of the 1980s was due to added incentives to work from lower effective tax rates on individuals. Incentives to invest and work go hand-in-hand. Investment incentives are necessary to create the job opportunities to spark interest in working and economic growth can only be sustained if the investment that creates new jobs can be activated by new job seekers.

Private credit growth of just 3 percent in the past year or so is the lowest on record. This reflects the fact that there are few worthwhile investment opportunities available because of the punitive tax and regulatory environment. New and accumulated savings have gravitated to safe investments — Treasury securities and blue chip stocks. There needs to be incentives to take risks. Laws must be removed that have stifled growth in the value of the nation's capital stock. Incentives to invest and work must be

restored. And regulation must be cut back.

If the Fed, as expected, acts to bolster a flagging economy before election day, we anticipate the fourth quarter will be as good or better than the third quarter. However, after the election, the Fed will have little reason to act dramatically and the economy will revert to a slow pace of growth. The economy's persistent problems stemming from anti-growth policies will lead to a tapering off in economic growth in 1993. It is the last half of 1993 and beyond that concerns us the most.

A nagging symptom of actual and expected slow economic growth is the federal budget deficit. The deficit is expected to reach about $350 billion this year and next and will be almost 6 percent of GDP in 1992. So far in fiscal year 1992, revenues are up from last year by almost $1 billion more per month. Spending is over $8 billion more per month than last year and is causing the deficit to be approximately $100 billion more than it was last year. Americans tend to believe the increase in spending is far too great compared to actual revenue increases. More prudent budgeting would have held down this year's deficit increase.

Most business people would suggest that the economy needs to grow much faster to generate the happy times they want and the revenues government would like to see. However, political debates during this year's election season have focused more on deficit reduction than on securing more economic growth. Unfortunately, even after the miserable failure of the tax increases in the 1990 Budget Reform Act, many politicians are calling for more taxes. The message imparted from elected officials in Washington is that they need to be "bribed" with some tax increases to do the responsible thing — to agree to spending cuts. In the past, they have slipped the bribe. In 1982, 1986 and again in 1990 politicians said they would reduce spending by $2 or more for every $1 allowed in increased taxes. We are still waiting.

President Bush's Mid-Session Review of the Budget published in July shows one way to reduce the deficit without tax increases. As a first step, the administration's deficit reduction strategy calls for capping spending increases on the fastest growing entitlement or mandatory spending programs. With a slight improvement in economic growth of 0.5 percentage points above what is expected, the President's spending restraint would lead to a balanced budget by 1997.

Outside of the political arena there is a remarkable agreement among analysts about how to get an additional 0.5 percentage points of growth per year. Some analysts who have looked at the economy's growth potential carefully conclude that the right pro-growth policies would increase economic growth by up to 1.5 percentage points per year.

Even a one percentage point increase, while not sounding like much, can add an enormous amount of output to the economy. In ten years, an extra one percentage point of growth each year would add $2.5 trillion to the economy. Assuming revenues will stay at 19 percent of GDP, this would generate an extra $500 billion in federal revenues in ten years.

There was a brief moment of "camelot" for the budget deficit. Between 1986 and 1988, the economy was growing above trend and federal spending growth was restrained. It was a period when the Gramm-Rudman-Hollings deficit reduction law was in force and the President would not allow tax rate increases to meet falling deficit targets. The result was a budget deficit that stayed about the same in nominal dollars, but fell markedly as a percent of the total economy. From where we are now in the despair over the huge and growing deficits, all that it would take to get the budget deficit moving in the right direction is a commitment to spending restraint and a serious program to spur economic growth.

More economic growth will come from cutting the taxes on capital formation and reducing the rate of growth in federal spending. At first, this appears to be a paradox or, at best, a crap shoot — cutting tax rates to generate more revenues and forcing government spending restraint when economic growth is slow. Yet, this formula worked. By 1984 when all the 1981 tax cuts were completely at work, federal revenues were rising at near double digit rates. Spending restraint later worked to keep earnings in the private sector. By 1989 when the tax incentives on capital were fully removed, revenue growth began to wane. The 1990 Budget Reform Act that raised taxes some more was supposed to correct this shortfall. However, government revenue estimates for the upcoming five-years have been trimmed by more than $500 billion since 1990. The revenue generating spigot of the robust 1980s has been turned off.

Many people still claim that the 1990 Budget Reform Act was worth it. Yet it appears that the Act was a massive failure. Federal spending growth has accelerated after it waived Gramm-Rudman-Hollings and raised taxes. The deficit has climbed permanently above $200 billion. And one supposed economic benefit that could only come from deficit reduction — reduced interest rates — has happened in spite of rising deficits.

At this writing, one Presidential candidate focuses excessively on deficit reduction and, hence, cannot bring himself to offer a bold economic plan of pro-growth tax cuts and regulatory containment. The other candidate, to his credit, acknowledges that it will take a lot more economic growth to bring the deficit down. Unfortunately, he offers few serious proposals to increase growth, proposes excessive new taxes and wants the government to spend more. On balance, the few positive economic benefits of the other candidate's plan are more than offset by anti-growth aspects.

One candidate takes us down the path of austerity that he claims leads to prosperity. The other claims prosperity is to be found through bigger, more intrusive government. Both paths have been trod before and both lead into the wilderness.